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Tax Benefits for Higher Education

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Contents

Important Changes for 1998

The Taxpayer Relief Act of 1997 (TRA 97) provides many new tax benefits for persons who are paying higher education costs for themselves and members of their families. These benefits include education tax credits, a new education individual retirement account (education IRA), withdrawals from traditional IRAs for higher education expenses, and a deduction for student loan interest. In addition, TRA 97 makes the rules for qualified state tuition programs more flexible and extends the exclusion from income for employer-provided educational assistance. These are all discussed separately in this publication.

Introduction

There are many tax benefits for families who are saving for or paying higher education costs or who are repaying student loans. Most of these benefits first become available in 1998 and can be claimed when you file your 1998 federal income tax return early in 1999. This publication will help you determine which benefits apply to you so that you can plan for your 1998 federal income tax return.

TIP *You may be able to reduce the amount of your federal income tax withholding throughout the year based on your estimated tax benefits for higher education. After you figure the amount of your estimated 1998 income, exclusions, deductions, and credit(s), see Publication 919,* Is My Withholding Correct for 1998? **Caution:** *You should check your withholding again during the year if there are changes to your personal or financial situation that would affect* *your expected 1998 tax liability, including your allowable higher education tax benefits.*

This publication explains the tax benefits for higher education costs. It covers the following topics:

- Two new education credits, the Hope credit and the lifetime learning credit,
- Using funds from IRAs to pay education costs,
- Student loans used to pay education costs,
- Using proceeds from state tuition programs to pay education costs,
- Excluding from income interest earned on certain savings bonds, and
- Excluding from income employer-provided educational assistance benefits.

This publication does not cover the itemized deduction you may be able to claim for work-related educational expenses. Information on that deduction can be found in Publication 508, *Educational Expenses.* This publication also does not cover scholarships that you may be able to exclude from your income. Information on scholarships can be found in Publication 520, *Scholarships and Fellowships.*

Useful Items

You may want to see:

Publication

☐ **508** Educational Expenses

☐ **520** Scholarships and Fellowships

☐ **525** Taxable and Nontaxable Income

☐ **550** Investment Income and Expenses

☐ **590** Individual Retirement Arrangements (IRAs)

See *How To Get More Information,* near the end of this publication, for information about getting these publications.

Education Tax Credits

Beginning in 1998, you may be able to claim the new tax credits for higher education costs. These are:

- The Hope credit, and
- The lifetime learning credit.

Rules that apply to both credits are explained first. The explanations are followed by rules that apply to each credit, choosing which credit to claim, the phaseout based on your income, and some examples that show how to figure the amount of your credits.

Rules That Apply to Both Credits

The amount of each credit is determined by the amount you pay for qualified tuition and related expenses for eligible students and the amount of your modified adjusted gross income.

These credits are subtracted from your tax but they are nonrefundable. This means if the credits are more than your tax, the excess is not refunded to you.

CAUTION *If your filing status is* **Married filing separate return,** *you cannot claim the higher education credits.*

The credits can first be claimed on your 1998 tax return that you file in 1999. You will have to show the eligible student's name and taxpayer identification number (usually a social security number) on your return. The instructions that come with the 1998 tax forms will explain how to claim the credits on your tax return.

What expenses qualify. Qualified tuition and related expenses are tuition and fees required for enrollment or attendance at an eligible educational institution. Qualified expenses ***do not include*** books, room and board, student activities, athletics (unless the course is part of the student's degree program), insurance, equipment, transportation, or other similar personal, living, or family expenses.

Prepaid expenses. If you pay for qualified tuition and related expenses for an academic period that begins in the first three months of the following year, you can use the prepaid amount in figuring your credit. For example, if you pay $2,000 in December 1998 for qualified tuition for the winter 1999 semester that begins in January 1999, you can use that $2,000 in figuring your 1998 credit.

CAUTION *You* **cannot** *use any amount you paid in 1997 in figuring higher education credits for your 1998 tax return.*

Who is an eligible student. You, your spouse, or an eligible dependent can be an eligible student. The student must be enrolled at an eligible educational institution for at least one academic period (semester, trimester, quarter) during the year.

An ***eligible dependent*** is a person for whom you claim a dependency exemption. It generally includes your unmarried child who is under age 19 or who is a full-time student under age 24 if you supply more than half the child's support for the year. (See Publication 501, *Exemptions, Standard Deduction, and Filing Information,* for details on dependency exemptions.) An ***eligible educational institution*** generally includes any accredited public, nonprofit, or proprietary postsecondary institution eligible to participate in the student aid programs administered by the Department of Education.

No double benefit allowed. If you claim a deduction for higher education expenses on your tax return, you cannot claim a credit for those same expenses. Similarly, if you pay higher education expenses with a ***tax-free*** scholarship, Pell grant, or employer-provided educational assistance, you cannot claim a credit for those amounts. You can, however, claim a credit for expenses paid with the student's earnings, loans, gifts, inheritances, and personal savings.

If a student receives a tax-free distribution from an education IRA in a particular tax year, none of that student's expenses can be used as the basis of a higher education credit for that tax year. However, the student can waive the tax-free treatment. See Education IRA, *later.*

Recapture of credit. If, in a later tax year, you receive a refund of an amount you used to figure a higher education credit, you may have to repay all or part of the credit.

Hope Credit

For expenses paid ***after*** December 31, 1997, for academic periods beginning after that date, you may be able to claim a Hope credit of up to $1,500 for the qualified tuition and related expenses paid for ***each*** eligible student (defined earlier). This credit may be claimed for only ***two*** taxable years for each eligible student.

Additional qualifications for the Hope credit. You can claim a Hope credit only for an eligible student (defined earlier) who also meets the following requirements:

1) Is enrolled in one of the first two years of postsecondary education (generally, the freshman or sophomore years of college),

2) Is enrolled in a program that leads to a degree, certificate, or other recognized educational credential,

3) Is taking at least one-half of the normal full-time work load for his or her course of study for at least one academic period beginning during the calendar year, and

4) Is free of any felony conviction for possessing or distributing a controlled substance.

Amount of credit. The amount of the Hope credit is 100% of the first $1,000 ***plus*** 50% of the next $1,000 you pay for each eligible student's qualified tuition and related expenses. The maximum amount of Hope credit you can claim in 1998 is $1,500 times the number of eligible students. This means that you can claim the full $1,500 for each eligible student for whom you pay at least $2,000 for qualified expenses. However, the credit may be reduced based on your modified adjusted gross income. See *Income Phaseout,* later.

Example. Jon and Karen are married and file a joint tax return. For 1998, they claim their daughter as a dependent on their tax return and their modified adjusted gross income is $70,000. Their daughter is in her sophomore (second) year of studies at the local university and Jon and Karen pay $4,300 in 1998 for her tuition costs.

Jon and Karen, their daughter, and the local university meet all of the requirements for the Hope credit. Jon and Karen can claim a $1,500 Hope credit in 1998. This is the maximum amount allowed for 1998.

How to figure the Hope credit. You can use the following worksheet to figure the amount of your 1998 Hope credit.

Hope credit:

1. Amount paid for qualified expenses in 1998	1.	
2. Enter the ***lesser*** of line 1 or $2,000	2.	

Note: *If the amount on line 2 is $2,000, skip lines 3 through 5 and enter $1,500 on line 6.*

3. Enter the ***lesser*** of $1,000 or the amount on line 2	3.	
4. Subtract the amount on line 3 from the amount on line 2	4.	
5. Multiply the amount on line 4 by 50%	5.	
6. Add the amounts on lines 3 and 5 but not more than $1,500. This is the amount of your Hope credit for 1998 (before phaseout)	6.	

Lifetime Learning Credit

For expenses paid ***after*** June 30, 1998, for academic periods beginning after that date, you may be able to claim a lifetime learning credit of up to $1,000 for the total qualified tuition and related expenses paid during the tax year for ***all*** eligible students (defined earlier) who are enrolled in eligible educational institutions. Unlike the Hope credit:

1) The lifetime learning credit is not based on the student's work load. It is allowed for one or more courses.

2) The lifetime learning credit is not limited to students in the first two years of postsecondary education.

3) Expenses for graduate-level degree work are eligible.

4) There is no limit on the number of years for which the lifetime learning credit can be claimed for each eligible student.

5) The amount you can claim as a lifetime learning credit does not vary (increase) based on the number of eligible students for whom you pay qualified expenses.

Amount of credit. The amount of the lifetime learning credit is 20% of the first $5,000 you pay for qualified tuition and related expenses for all eligible students in the family. The maximum amount of lifetime learning credit you can claim for 1998 is $1,000 (20% times $5,000). However, that amount may be reduced based on your modified adjusted gross income. See *Income Phaseout,* later.

Example. Bruce and Toni are married and file a joint tax return. For 1998, their modified adjusted gross income will be $50,000. Toni is attending the community college (an eligible educational institution) to earn credits towards an associate's degree in nursing; she already has a bachelor's degree in history and wants to become a nurse. In August 1998, Toni will pay $2,000 for her fall 1998 semester. Bruce and Toni can claim a $400 (20% × $2,000) lifetime learning credit on their 1998 joint tax return.

Table 1. **Higher Education Tax Credits at a Glance**

Do not rely on this chart alone. It provides only general highlights of some of the differences between the two credits. ***See the text for definitions.***

	Hope credit	**Lifetime learning credit**
When can I start counting expenses I paid?	January 1, 1998	July 1, 1998
How many years can I claim the credit?	2 years per student	No limit
How much of the expenses I pay can qualify for the credit?	Up to $2,000 for **each** eligible student	Up to a total of $5,000 for all eligible students **per family**
	Note: *You can claim only one of these credits for each student's expenses for each tax year.*	
What is the maximum amount of the credit I can claim?	$1,500 per eligible student	$1,000 total for all eligible students per family
	Note: *The maximum amount of credit that can be claimed may be reduced based on your income.*	
How does the amount of my income affect the amount I can claim as a credit?	Your credit is reduced if your modified adjusted gross income is between: • $40,000 – $50,000, or • $80,000 – $100,000 in the case of a joint return. You cannot claim the credits if your modified adjusted gross income is above these limits. You cannot claim the credit if you are married filing a separate return.	

How to figure the lifetime learning credit. You can use the following worksheet to figure the amount of your lifetime learning credit for 1998.

Lifetime learning credit:

1. Amount paid for qualified expenses after June 1998 .... 1. ______
2. Enter the ***lesser*** of line 1 or $5,000 .... 2. ______
3. Multiply the amount on line 2 by 20%. This is the amount of your lifetime learning credit for 1998 (before phaseout) .... 3. ______

Choosing Which Credit To Claim

For each eligible student, you can elect for any tax year only ***one*** of the credits ***or*** a tax-free withdrawal from an education IRA. (See *Education IRA* for more information.) For example, if you elect to take the Hope credit for a child on your 1998 tax return, you cannot, for that same child, also claim the lifetime learning credit for 1998 or take a tax-free withdrawal from an education IRA for 1998.

You can claim the Hope credit for the first two years of a child's postsecondary education and claim the lifetime learning credit for that same child in later tax years.

If you pay qualified expenses for more than one eligible student in the same year, you can choose to take credits on a per-student, per-year basis. That means that, for example, you can claim the Hope credit for one child and the lifetime learning credit for another child in the same tax year.

In any one tax year, only one person can claim a higher education credit for an eligible student's expenses. If you are paying higher education costs for your dependent child, either you or your dependent child, but not both, can claim a credit for a particular year. If you claim an exemption for your child on your tax return, only you can claim a credit. If you do not claim an exemption for your child on your tax return, only your child can claim a credit.

TIP *If you claim an exemption for your child on your tax return, treat any expenses paid by your child as if you had paid them. Include these expenses when figuring the amount of your Hope or lifetime learning credit.*

Income Phaseout

Your education credits are phased out (gradually reduced) if your modified adjusted gross income is between $40,000 and $50,000 ($80,000 and $100,000 in the case of a joint return).

CAUTION *You cannot claim* **any** *higher education credits if your modified adjusted gross income is over $50,000 ($100,000 in the case of a joint return).*

For most taxpayers, ***modified adjusted gross income*** will be their adjusted gross income (AGI) as figured on their federal income tax return. However, you must make adjustments to your AGI if you have income earned abroad or from certain U.S. territories or possessions. If this applies to you, increase your AGI by the following amounts.

1) Certain amounts you earn abroad.

2) Amounts effectively connected with your trade or business or derived from sources in Guam, American Samoa, or the Northern Mariana Islands (if you are a resident of the possession where the source of the income is located).

3) Amounts derived from sources in Puerto Rico (if you are a Puerto Rican resident).

How the phaseout works. The phaseout (reduction) works on a sliding scale. The higher your modified adjusted gross income, the more your credits are reduced. You reduce the total of your education credits by a fraction. The numerator is the amount of your modified adjusted gross income that is over \$40,000 (\$80,000 in the case of a joint return) and the denominator is \$10,000 (\$20,000 in the case of a joint return).

$$\frac{\text{Modified AGI - \$40,000 (Use \$80,000 in the case of a joint return)}}{\text{\$10,000 (Use \$20,000 in the case of a joint return)}}$$

Example 1. Bill and Kathy are married and file a joint tax return. They have an otherwise allowable Hope credit of \$3,000 for 1998. Their modified adjusted gross income is \$85,000. They must reduce their otherwise allowable credit by a fraction. They compute the numerator, \$5,000, by subtracting \$80,000 from their modified adjusted gross income of \$85,000. The denominator is \$20,000. The result (\$5,000 ÷ \$20,000) is $\frac{1}{4}$.

Bill and Kathy reduce their \$3,000 Hope credit by $\frac{1}{4}$ (\$750). They can claim a \$2,250 (\$3,000 – \$750) Hope credit in 1998.

Example 2. Jackie, a single taxpayer, has an otherwise allowable lifetime learning credit of \$500 for 1998. Her modified adjusted gross income is \$42,000. She must reduce her otherwise allowable credit by a fraction. She computes the numerator, \$2,000, by subtracting \$40,000 from her modified adjusted gross income of \$42,000. The denominator is \$10,000. The result (\$2,000 ÷ \$10,000) is $\frac{1}{5}$.

Jackie reduces her \$500 lifetime learning credit by $\frac{1}{5}$ (\$100). She can claim a \$400 (\$500 – \$100) lifetime learning credit in 1998.

Examples

The following examples illustrate how to apply the rules for the higher education tax credits.

Example 1. Jim, a single taxpayer, enrolled full-time at a local college to earn a degree in computer science. This is the first year of his postsecondary education. During 1998, he paid \$1,600 for his qualified 1998 tuition, and he and the college meet all of the requirements for the Hope credit. Jim's modified adjusted gross income is \$34,000. He figures his allowable amount for 1998, \$1,300, as follows.

Hope credit for Jim:

1. Amount paid for Jim's qualified expenses in 1998	1.	\$1,600
2. Enter the ***lesser*** of line 1 or \$2,000	2.	1,600

Note: *If the amount on line 2 is \$2,000, skip lines 3 through 5 and enter \$1,500 on line 6.*

3. Enter the ***lesser*** of \$1,000 or the amount on line 2	3.	1,000
4. Subtract the amount on line 3 from the amount on line 2	4.	600
5. Multiply the amount on line 4 by 50%	5.	300
6. Add the amounts on lines 3 and 5 but not more than \$1,500. This is the amount of your Hope credit for 1998 (before phaseout)	6.	\$1,300

Jim's credit is not subject to the phaseout.

Example 2. Judy, a single taxpayer, is taking courses at a community college to be recertified to teach in the public schools. Her modified adjusted gross income is \$22,000. In July 1998, she pays \$700 for the summer 1998 semester; in August 1998 she pays \$1,900 for the fall 1998 semester; and in December 1998 she pays another \$1,900 for the winter 1999 semester. Judy and the college meet all of the requirements for the lifetime learning credit. She can use all of the \$4,500 tuition she paid in 1998 when figuring her credit for her 1998 tax return. She figures her credit as follows.

Lifetime learning credit for Judy:

1. Amount paid for Judy's qualified expenses after June 1998	1.	\$4,500
2. Enter the ***lesser*** of line 1 or \$5,000	2.	4,500
3. Multiply the amount on line 2 by 20%. This is the amount of your lifetime learning credit for 1998 (before phaseout)	3.	\$900

Judy's credit is not subject to the phaseout.

Example 3. Dave and Valerie are married and file a joint tax return. For 1998, they claim their two children as dependents on their tax return, and their modified adjusted gross income is \$72,000. Their son, Sean, will receive his bachelor's degree in psychology from the state college in May 1999. Their daughter, Corey, enrolled full-time at that same college in August 1997 to begin working on her bachelor's degree in physical education. In December 1997, Dave and Valerie paid \$2,000 for each child's tuition for the winter 1998 semester. In July 1998, they pay \$2,200 in tuition costs for each of them for the fall 1998 semester.

Dave and Valerie, their children, and the college meet all of the requirements for the higher education credits. Because Sean is beyond the second (sophomore) year of his postsecondary education, his expenses do not qualify for the Hope credit. But, amounts paid for Sean's expenses after June 1998 for academic periods after June 1998 qualify for the lifetime learning credit. Corey is in her first (freshman) year of postsecondary education and expenses paid for her in 1998 qualify for the Hope credit. (Payments made in 1997 are not eligible for either credit.)

Dave and Valerie figure their total higher education credits for 1998 as shown in the following worksheets.

Lifetime learning credit for Sean:

1. Amount paid for Sean's qualified expenses after June 1998	1.	$2,200
2. Enter the ***lesser*** of line 1 or $5,000	2.	2,200
3. Multiply the amount on line 2 by 20%. This is the amount of your lifetime learning credit for 1998 (before phaseout)	3.	$440

Hope credit for Corey:

1. Amount paid for Corey's qualified expenses in 1998	1.	$2,200
2. Enter the ***lesser*** of line 1 or $2,000	2.	2,000

Note: *If the amount on line 2 is $2,000, skip lines 3 through 5 and enter $1,500 on line 6.*

3. Enter the ***lesser*** of $1,000 or the amount on line 2	3.	
4. Subtract the amount on line 3 from the amount on line 2	4.	
5. Multiply the amount on line 4 by 50%	5.	
6. Add the amounts on lines 3 and 5 but not more than $1,500. This is the amount of your Hope credit for 1998 (before phaseout)	6.	$1,500

Because their modified adjusted gross income is not more than $80,000, Dave and Valerie's credits are not subject to the phaseout. They add the totals of their two worksheets to arrive at $1,940. This is the amount of higher education credits Dave and Valerie can claim for 1998.

Individual Retirement Arrangement (IRA) Provisions

Beginning in 1998, you may be able to establish an education individual retirement account (education IRA or Ed IRA) to finance a child's qualified higher education expenses. In addition, you may be able to make withdrawals from a traditional IRA without paying the 10% tax on early withdrawals if you pay for qualified higher education expenses.

Education IRA

Beginning in 1998, you may be able to contribute up to $500 each year to an education IRA for a child under age 18. Contributions to an education IRA are not deductible.

Any individual (including the child) can contribute to a child's education IRA if the individual's modified adjusted gross income (defined later) is not more than $110,000 ($160,000 in the case of a joint return). The $500 maximum contribution for each child is gradually reduced if the individual's modified adjusted gross income is between $95,000 and $110,000 (between $150,000 and $160,000 in the case of a joint return). See *Contributions,* later.

There is no limit on the number of education IRAs that can be established designating a child as the beneficiary. However, total contributions for the child during any tax year cannot be more than $500.

Amounts deposited in the accounts grow tax free until distributed (withdrawn).

If, for a year, withdrawals from an account are not more than a child's qualified higher education expenses (defined later) at an eligible educational institution (defined later), the child will not owe tax on the withdrawals. See *Distributions,* later, for more information.

Education IRAs At a Glance

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
What is an **education IRA?**	An IRA that is set up to pay the **qualified higher education expenses** of a designated beneficiary.
Where can it be established?	It can be opened in the United States at any bank or other IRS-approved entity that offers education IRAs.
Who can an education IRA be set up for?	Any child who is under age 18.
Who can contribute to an education IRA?	Generally, any individual (including the beneficiary) whose **modified adjusted gross income** for the year is not more than $110,000 ($160,000 in the case of a joint return).

What Is an Education IRA?

An education IRA is a trust or custodial account created only for the purpose of paying the qualified higher education expenses (defined later) of the designated beneficiary of the account. When the account is established, the designated beneficiary must be a child under age 18. To be treated as an education IRA, the account must be designated as an education IRA when it is created.

Trust requirements. The document creating and governing the trust must be in writing and must satisfy the following requirements.

1) The trust must be created or organized in the United States.

2) The trustee must be a bank or an entity approved by the IRS.

3) The trust must provide that the trustee can only accept a contribution that:

   a) Is in cash,

   b) Is made before the beneficiary reaches age 18, and

   c) Would not result in total contributions for the tax year (not including rollover contributions) being more than $500.

4) Money in the account cannot be invested in life insurance contracts.

5) Money in the account cannot be combined with other property except in a common trust fund or common investment fund.

6) If the beneficiary dies, any balance in the account must be distributed to the beneficiary's estate within 30 days after the date of death.

Qualified higher education expenses. These are expenses required for the enrollment or attendance of the designated beneficiary at an eligible educational institution. The term “qualified higher education expenses” means expenses for:

1) Tuition,

2) Fees,

3) Books,

4) Supplies, and

5) Equipment.

The term also includes:

1) Amounts contributed to a qualified state tuition program. (See *State Tuition Programs,* later.)

2) Room and board if the designated beneficiary is at least a half-time student at an eligible educational institution. A student is enrolled at least half-time if he or she is enrolled for at least half the full-time academic work load for the course of study the student is pursuing as determined under the standards of the institution where the student is enrolled. Room and board is limited to:

a) The school's posted room and board charge for students living on campus, or

b) $2,500 each year for students living off campus and not at home.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually any accredited public, nonprofit, or proprietary (privately owned profit-making) postsecondary institution.

Contributions

Any individual (including the child for whose benefit the account is established) can contribute to a child's education IRA if the individual's modified adjusted gross income (defined later) for the tax year is less than $110,000 ($160,000 in the case of a joint return).

Contributions can be made to one or several education IRAs for the same child provided that the total contributions are not more than the contribution limit (defined later) for a tax year.

Education IRA Contributions At a Glance

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Are contributions deductible?	No.
Why should someone contribute to an education IRA?	It is a new tax benefit for families saving for higher education costs.
What is the **contribution limit?**	$500 each year for each child.
What if more than one education IRA has been opened for the same child?	The annual contribution limit is $500 for each child, no matter how many education IRAs are set up for that child.
What if more than one individual makes contributions for the same child?	The contribution limit is $500 per child, no matter how many individuals contribute.
Can contributions other than cash be made to an education IRA?	No.
When can a taxpayer first contribute to an education IRA?	1998.
When must contributions stop?	No contributions can be made to a child’s education IRA after he or she reaches age 18.

Qualified state tuition program. No contributions can be made to an education IRA on behalf of a child if any amount is contributed during the tax year to a qualified state tuition program on behalf of the same child.

Contribution limit. The maximum total contribution for each child is $500 for a tax year. This includes contributions to all the child's education IRAs from all sources other than rollovers. See *Rollovers and Other Transfers,* later.

Reduced limit for certain contributors. If your modified adjusted gross income (defined later) is between $95,000 and $110,000 (between $150,000 and $160,000 in the case of a joint return), the $500 maximum contribution for each child is gradually reduced. If your modified adjusted gross income is $110,000 or more ($160,000 or more in the case of a joint return), you cannot contribute to anyone's education IRA.

Figuring the limit. To figure the limit, multiply $500 by a fraction. The numerator is your modified adjusted gross income minus $95,000 ($150,000 in the case of a joint return). The denominator is $15,000 ($10,000 in the case of a joint return). Subtract the result from $500. This is the amount you can deduct.

Example. Paul, a single individual, had modified adjusted gross income of $96,500 for the year. For Paul, the maximum contribution for each child is reduced to $450, figured as follows.

1) $96,500 − $95,000 = $1,500
2) $1,500 ÷ $15,000 = 10%
3) 10% × $500 = $50
4) $500 − $50 = $450

Modified adjusted gross income. For the purpose of determining the maximum contribution limit, your modified adjusted gross income is the adjusted gross income shown on your return increased by the following exclusions from your income.

1) Foreign earned income of U.S. citizens or residents living abroad.
2) Housing costs of U.S. citizens or residents living abroad.
3) Income from sources within:
   a) Puerto Rico,
   b) Guam,
   c) American Samoa, or
   d) The Northern Mariana Islands.

Other contribution rules. You can contribute only cash to an education IRA. You cannot contribute to an education IRA after the child who is the beneficiary reaches his or her 18th birthday.

Additional tax on excess contributions. A 6% excise tax applies to:

1) Contributions that are more than $500 for the tax year for a child, and
2) Any contributions to the account if any amount is also contributed to a qualified state tuition program on behalf of the same child in the same tax year.

The excise tax does not apply if the excess contributions (and any earnings on them) are withdrawn before the tax return for the year is due.

Distributions

In general, the designated beneficiary of an education IRA can receive tax-free withdrawals to pay qualified higher education expenses. The withdrawals are tax free to the extent the withdrawal does not exceed the beneficiary's qualified higher education expenses. See *Rollovers and Other Transfers,* later.

Education IRA Withdrawals At a Glance

Do not rely on this chart alone. It provides only general highlights. See the text for definitions of terms in bold type and for more complete explanations.

Question	Answer
Is a withdrawal from an education IRA to pay for a designated beneficiary's qualified higher education expenses tax-free?	Generally, the withdrawal is tax free to the designated beneficiary to the extent the amount of the withdrawal does not exceed the designated beneficiary's qualified higher education expenses.
After the designated beneficiary completes his or her education at an **eligible educational institution,** may amounts remaining in the education IRA be withdrawn?	Yes. Also, certain transfers to **members of the designated beneficiary's family** are permitted.
Does the designated beneficiary need to be enrolled for a minimum number of courses to take a tax-free withdrawal to pay qualified higher education expenses?	No.

Tax treatment. The tax treatment of distributions (withdrawals) from an education IRA depends, in part, on the amount of qualified higher education expenses that the beneficiary has in a tax year.

Distributions not more than expenses. Generally, a withdrawal is tax free to the beneficiary if it is not more than his or her qualified higher education expenses in a tax year.

Distributions more than expenses. Generally, if the total withdrawals for a tax year are more than the qualified higher education expenses, a portion of the amount withdrawn is taxable to the beneficiary.

The taxable portion is the amount that represents earnings that have accumulated tax free in the account. Figure the taxable portion as shown in the following steps.

1) Multiply the amount withdrawn by a fraction. The numerator is the total contributions in the account and the denominator is the total balance in the account before the withdrawal(s).
2) Subtract the amount figured in *(1)* from the total amount withdrawn during the year. This is the amount of earnings included in the withdrawal(s).
3) Multiply the amount of earnings figured in *(2)* by a fraction. The numerator is the qualified higher education expenses paid during the year and the de-

nominator is the total amount withdrawn during the year.

4) Subtract the amount figured in *(3)* from the amount figured in *(2).* This is the amount the beneficiary must include in income.

Example. You receive a $6,000 distribution from an education IRA to which $10,000 has been contributed. The balance in the IRA before the withdrawal was $12,000. You had $4,500 of qualified higher education expenses for the year. Using the steps above, you figure the taxable portion of your withdrawal as follows.

1) $6,000 × ($10,000 ÷ $12,000) = $5,000

2) $6,000 - $5,000 = $1,000

3) $1,000 x ($4,500 ÷ $6,000) = $750

4) $1,000 - $750 = $250

You must include $250 in income as withdrawn earnings not used for the expenses of higher education.

The Hope credit and lifetime learning credit cannot be claimed for a student's qualified higher education expenses in the same tax year in which the student receives a tax-free withdrawal from an education IRA. But see Waiver of tax-free treatment, *next.*

Waiver of tax-free treatment. The student may waive the tax-free treatment of the education IRA distribution and elect to pay any tax that would otherwise be owed on the distribution. The student or the student's parents may then be eligible to claim a Hope credit or lifetime learning credit for qualified higher education expenses paid in that tax year. (See *Education Tax Credits,* earlier, to determine if you meet all of the requirements for those credits.)

Additional tax. Generally, if you receive a taxable distribution, you also must pay a 10% additional tax on the amount included in income.

Exceptions. The 10% additional tax does not apply to distributions that are:

1) Made to a beneficiary (or to the estate of the designated beneficiary) on or after the death of the designated beneficiary.

2) Made because the designated beneficiary is disabled (defined later).

3) Made because the designated beneficiary received a qualified scholarship excludable from gross income, an educational assistance allowance, or payment for the designated beneficiary's educational expenses that is excludable from gross income under any law of the United States to the extent the distribution is not more than the scholarship, allowance, or payment.

The 10% additional tax also does not apply to a distribution that is a return of an excess contribution. For the additional tax not to apply, the distribution must be made before the due date of the contributor's tax return (including extensions) and it must include any net income attributable to that contribution. That net income also must be included in the contributor's gross income for the tax year the contribution was made.

Disabled. You are considered to be disabled if you show proof that you cannot do any substantial gainful activity because of your physical or mental condition. A physician must determine that your condition can be expected to result in death or to be of long-continued and indefinite duration.

Rollovers and Other Transfers

Any amount withdrawn from an education IRA and rolled over to another education IRA for the benefit of the same beneficiary or certain ***members of the beneficiary's family*** is not taxable. An amount is rolled over if it is paid to another education IRA within 60 days after the date of the withdrawal.

Only one rollover per education IRA is allowed during a 12-month period ending on the date of the payment or distribution.

The designated beneficiary can be changed from one child to a member of that child's family without triggering any tax consequences. Members of the child's family include the child's:

1) Children and their descendents.

2) Stepchildren and their descendents.

3) Brothers and sisters and their children.

4) Parents and grandparents.

5) Stepparents.

6) Spouses of all of the family members listed above.

Transfer incident to divorce. The transfer of a designated beneficiary's interest in an education IRA to his or her spouse or former spouse under a divorce or separation instrument is not a taxable transfer. After the transfer, the interest will be treated as an education IRA in which the spouse or former spouse is the designated beneficiary.

Transfer because of death. The tax treatment of a transfer because of death depends on whether you are the surviving spouse.

Surviving spouse. If your spouse was the designated beneficiary of an education IRA and you receive the education IRA as a result of the death of your spouse, you can treat the education IRA as your own.

Someone other than surviving spouse. If you are someone other than the surviving spouse of the designated beneficiary and you receive an education IRA as the result of the death of the IRA holder, the distribution to you is taxable at its fair market value. You cannot treat the IRA as your own.

Withdrawals From Traditional IRAs

Beginning in 1998, you can receive distributions from your traditional IRA for qualified higher education expenses. A traditional IRA is an IRA that is not a Roth IRA, SIMPLE IRA, or education IRA. You will owe income tax on at least part of the distribution but you will not have to pay the 10% tax on early withdrawals. (Generally, if you receive distributions from your traditional IRA before you reach age $59\frac{1}{2}$, you must pay a 10% tax on the early withdrawal.)

Withdrawals for higher education expenses. Part (or all) of any withdrawal may not be subject to the 10% tax on early withdrawals. The part not subject to the tax is generally the amount that is not more than the qualified higher education expenses (defined later) for higher education furnished at an eligible educational institution (defined later). The education must be for you, your spouse, or the children or grandchildren of you or your spouse.

When determining the amount of the withdrawal that is not subject to the 10% tax, ***include*** qualified higher education expenses paid with any of the following funds.

1) An individual's earnings.
2) A loan.
3) A gift.
4) An inheritance given to either the student or the individual making the withdrawal.
5) Personal savings (including savings from a qualified state tuition program).

Do ***not include*** expenses paid with any of the following funds.

1) Tax-free distributions from an education IRA.
2) Tax-free scholarships, such as a Pell grant.
3) Tax-free employer-provided educational assistance.
4) Any tax-free payment (other than a gift, bequest, or devise) due to enrollment at an eligible education institution.

Qualified higher education expenses. Qualified higher education expenses are tuition, fees, books, supplies and equipment required for the enrollment or attendance of a student at an eligible educational institution. In addition, if the individual is at least a half-time student, room and board are qualified higher education expenses.

Eligible educational institution. This is any college, university, vocational school, or other postsecondary educational institution eligible to participate in the student aid programs administered by the Department of Education. It includes virtually all accredited, public, nonprofit, and proprietary (privately owned profit-making) postsecondary institutions. The educational institution should be able to tell you if it is an eligible educational institution.

Student Loans

Beginning in 1998, you may be able to deduct interest you pay on a qualified student loan. This applies to loan interest payments due and paid after 1997. And, if a student loan is canceled, you may not have to include any amount in income.

Interest Deduction

You may be able to deduct interest you pay on a qualified student loan even if you took out the loan before 1998. Regardless of when you took out the loan, you can deduct only interest paid during the ***first 60 months*** that interest payments are required. Months when you do not have to make payments because your loan is deferred or in forbearance do not count against the 60-month period.

Example. You took out a qualified student loan in 1993. You make a payment on the loan every month as required, beginning October 1, 1993. You can deduct the interest on your first nine payments for 1998. You cannot deduct the interest on any later payments because they are after the 60-month period (October 1, 1993 – September 30, 1998).

Your interest deduction for 1998 cannot be more than $1,000 and is subject to the limit described later.

Claiming the deduction. This deduction is an adjustment to income, so you can claim it even if you do not itemize your deductions on Schedule A (Form 1040).

You cannot claim the deduction if:

1) Another taxpayer claims you as a dependent, or
2) Your filing status is married filing a separate return.

Change in dependency status. You cannot deduct interest on a student loan for any year you are claimed as a dependent on another person's tax return. But you can, subject to the other requirements explained here, deduct payments made in a later year when you are no longer claimed as a dependent.

Qualified student loan. This is a loan you took out to pay qualified higher education expenses. The expenses must have been:

1) For you, your spouse, or a person who was your dependent when you took out the loan,
2) Paid or incurred within a reasonable time before or after you took out the loan, and
3) For education furnished during a period when the recipient was an eligible student.

Qualified higher education expenses. These expenses are the costs of attending an eligible educational institution, including graduate school. Generally, these costs include tuition, fees, room and board, books, equipment, and other necessary expenses, such as transportation. But you must reduce these costs by the following items.

1) Nontaxable employer-provided educational assistance benefits.
2) Nontaxable distributions from an education IRA.
3) U.S. savings bond interest that is nontaxable because you paid qualified higher education expenses.
4) Qualified scholarships that are nontaxable.
5) Veterans' educational assistance benefits.

6) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses.

Eligible educational institution. Generally, this means either of the following.

1) A college, university, vocational school, or other postsecondary educational institution eligible to participate in Department of Education student aid programs. This category includes virtually all accredited public, nonprofit, and proprietary postsecondary institutions.

2) An institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility that offers postgraduate training.

Eligible student. An eligible student is one who:

1) Is enrolled in a degree, certificate, or other program (including a program of study abroad that is approved for credit by the institution at which the student is enrolled) leading to a recognized educational credential at an eligible educational institution, and

2) Is carrying at least one-half the normal full-time work load for the course of study the student is pursuing.

Loan from related person. You cannot deduct interest on a loan you get from a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

Refinanced loan. If you refinance a qualified student loan, the new loan can also be a qualified student loan. But refinancing a loan does not extend the 60-month period described earlier. The 60-month period is based on the original loan.

Maximum deduction. Your deduction for 1998 cannot be more than $1,000. This limit increases to $1,500 for 1999, $2,000 for 2000, and $2,500 for 2001 and later years.

Limit on deduction. Your deduction may be limited, depending on the amount of your modified adjusted gross income. This limit applies if your modified adjusted gross income is more than $40,000 ($60,000 in the case of a joint return).

If your modified adjusted gross income is more than $55,000 ($75,000 in the case of a joint return), you cannot claim a deduction.

Modified adjusted gross income. For purposes of this deduction, modified adjusted gross income means adjusted gross income figured before this deduction for student loan interest and modified by adding back any of the following items.

1) U.S. savings bond interest that is nontaxable because you paid qualified higher educational expenses.

2) Nontaxable employer-provided adoption assistance benefits.

3) Foreign earned income exclusion.

4) Foreign housing exclusion or deduction.

5) Exclusion of income for bona fide residents of American Samoa.

6) Exclusion of income from Puerto Rico.

Figuring the limit. To figure the limit, multiply your deduction (before the limit) by a fraction. The numerator is your modified adjusted gross income minus $40,000 ($60,000 in the case of a joint return). The denominator is $15,000. Subtract the result from your deduction (before the limit). This result is the amount you can deduct.

Example 1. During 1998 you paid $900 interest on a qualified student loan. Your 1998 modified adjusted gross income is $70,000 and you are filing a joint return. You must reduce your deduction (before the limit) by $600, figured as follows.

$$\$900 \times \frac{\$70,000 - \$60,000}{\$15,000} = \$600$$

You can deduct $300 ($900 – $600).

Example 2. The facts are the same as in *Example 1* except that you paid $1,600 interest. Your maximum deduction for 1998 is $1,000. You must reduce your maximum deduction by $667, figured as follows.

$$\$1,000 \times \frac{\$70,000 - \$60,000}{\$15,000} = \$667$$

You can deduct $333 ($1,000 – $667).

No double benefit. You cannot deduct as interest on a student loan any amount you can deduct under any other provision of the tax law (for example, as home mortgage interest).

Cancellation of Loan

Certain student loans contain a provision that all or part of the debt incurred to attend a qualified educational institution will be canceled if you work for a certain period of time in certain professions for any of a broad class of employers. You do not have income if your student loan is canceled because you agreed to this provision and performed the services required. To qualify, the loan must have been made by:

1) The government — federal, state, or local, or an instrumentality, agency, or subdivision thereof,

2) A tax-exempt public benefit corporation that has assumed control of a state, county, or municipal hospital, and whose employees are considered public employees under state law, or

3) An educational institution under an agreement with an entity described in (1) or (2) that provided the funds to the institution to make the loan.

Loans canceled after August 5, 1997. The exclusion from income of debt canceled on certain student loans has been expanded for loans canceled after August 5, 1997. If your loan was canceled after August 5, 1997, you do not have to include the canceled debt in income if both of the following are true.

1) The loan was made by an educational institution as part of its program designed to encourage students to serve in occupations or areas with unmet needs.
2) The services are provided for or under the direction of a governmental unit or a tax-exempt section 501(c)(3) organization.

You also do not have to include any of the canceled debt in income if the loan was made by an educational institution or a tax-exempt section 501(c)(3) organization to refinance another student loan if cancellation of that other loan would not require you to include any amount in income.

An ***educational institution*** is an organization with a regular faculty and curriculum and a regularly enrolled body of students in attendance at the place where the educational activities are carried on.

A ***section 501(c)(3) organization*** is any corporation, community chest, fund, or foundation organized and operated exclusively for one or more of the following purposes.

- Charitable.
- Religious.
- Educational.
- Scientific.
- Literary.
- Testing for public safety.
- Fostering national or international amateur sports competition (but only if none of its activities involve providing athletic facilities or equipment).
- The prevention of cruelty to children or animals.

Exception. You do have taxable income if your student loan is canceled because of services performed for an educational institution.

State Tuition Programs

Certain states and agencies maintain programs that allow people to purchase credits or certificates or make contributions to an account to pay for future education. Contributions to a qualified state tuition program are not deductible, and distributions are taxable only to the extent they are more than the amount contributed to the program.

A qualified state tuition program is one that is established and maintained by a state or agency and that:

1) Allows a person to:
   a) Buy tuition credits or certificates for a designated beneficiary who would then be entitled to a waiver or payment of qualified higher educational expenses, or
   b) Make contributions to an account that is set up to meet the qualified higher educational expenses of a designated beneficiary of the account,
2) Requires all purchases or contributions to be made only in cash,
3) Prohibits the contributor and the beneficiary from directing the amount invested, and
4) Allows a change of beneficiary to be made only between members of the same family.

Beginning January 1, 1998, the definition of ***members of the same family*** has been expanded and now includes the following relationships.

Parent	Brother-in-law
Grandparent	Sister-in-law
Brother	Son-in-law
Sister	Daughter-in-law
Stepbrother	Brother of a parent
Stepsister	Sister of a parent
Stepmother	Son of a sibling
Stepfather	Daughter of a sibling
Stepdaughter	Stepson
Mother-in-law	Half brother
Father-in-law	Half sister

Spouses of the persons listed above are also members of the same family.

For more information on a specific state tuition program, contact the state or agency that established and maintains it.

Education Savings Bonds

You can exclude from your gross income interest on qualified U.S. savings bonds if you have qualified higher educational expenses during the redemption year.

Beginning in 1998, when figuring the interest you can exclude, include as a qualified higher educational expense any contribution to a qualified state tuition program. Do not include any expense you use to claim the Hope credit or the lifetime learning credit.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a Series EE U.S. savings bond ***issued after 1989.*** The bond must be issued either in your name (as the sole owner) or in your and your spouse's names (as co-owners). You must be at least 24 years old before the bond's issue date.

Qualified expenses. Qualified higher education expenses are tuition and fees required for you, your spouse, or your dependent for whom you claim an exemption to attend an eligible educational institution. Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program. An ***eligible educational institution*** is generally any public or nonprofit university, college, or vocational school that is eligible for federal funding.

Amount excludable. For information on figuring the amount of excludable interest, see *Education Savings Bond Program* in chapter 1 of Publication 550.

Employer-Provided Educational Assistance

If you received educational assistance benefits from your employer, all or part of the benefits may be tax free.

You can exclude from income up to $5,250 of the benefits you receive under a qualified educational assistance program. Your employer can tell you if the program is a qualified program. The education does not have to be work related for the benefits to be excluded.

The exclusion, which previously applied only to benefits you received in tax years beginning before June 1, 1997, for courses that began before July 1, 1997, has been reinstated retroactively and extended. It now applies to benefits you receive for courses that begin before June 1, 2000. However, the exclusion does not apply to benefits for graduate level courses (discussed later) that began after June 30, 1996.

CAUTION *If you received more than $5,250 of benefits for the year, the amount over $5,250 is taxable and must be included in your income, unless it qualifies as a working condition fringe benefit. See* Excludable fringe benefit, *later.*

Educational assistance benefits. Educational assistance benefits include payments by your employer for tuition, fees and similar expenses, books, supplies, and equipment. It does not include payments for meals, lodging, transportation, or tools or supplies (other than textbooks) that you can keep after completing the course of instruction. It does not include payments for education involving sports, games, or hobbies unless the education:

1) Has a reasonable relationship to the business of your employer, or

2) Is required as part of a degree program.

Graduate level course. Educational assistance benefits do not include any payments by your employer for a graduate level course normally taken under a program leading to a law, business, medical, or other advanced academic or professional degree if the course began after June 30, 1996.

Expenses paid with benefits. If you received tax-free benefits under your employer's qualified educational assistance program, you cannot take a deduction for qualified educational expenses.

Excludable fringe benefit. If your employer-provided educational assistance is not excludable under the rules for qualified educational assistance programs, it may still be excludable if it qualifies as a working condition fringe benefit. A working condition fringe benefit is a benefit which, if you had paid for it, you could have deducted as an employee business expense. For more information on fringe benefits, see chapter 4 of Publication 535, *Business Expenses.*

Refund of prior year tax. If you paid taxes on excludable benefits for an earlier tax year, you may be able to get a refund of those taxes. For information, see *Refund Procedures* under *Employer-Provided Educational Assistance* in Publication 508.

CAUTION *If you had educational expenses that you excluded from gross income under your employer's educational assistance program, you cannot take the Hope credit or the lifetime learning credit for these same expenses.*

How To Get More Information

You can get help from the IRS in several ways.

Free publications and forms. To order free publications and forms, call 1–800–TAX–FORM (1–800–829–3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services.* It also contains an index of tax topics and related publications and describes other free tax information services available from IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

Tax questions. You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1–800–829–1040.

TTY/TDD equipment. If you have access to TTY/TDD equipment, you can call 1–800–829–4059 to ask tax questions or to order forms and publications. See your income tax package for the hours of operation.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our “800 number” telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.

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